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# MANAGING FARM CREDIT



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# MANAGING FARM CREDIT

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**This is a reprint of the contents of Publication 14 "Farm Credit In Ontario"**

## MANAGING FARM CREDIT

Credit counselling is an essential component of farm business management. Advice on the type and the use of credit can be obtained from any one of the County and District Offices of the Ministry of Agriculture, Food and Rural Affairs. This publication and publication 379, **MONEY MATTERS** can be used as sources of information on farm financial management. Publication 37 - Farm Financial Analysis and Planning Workbook can be used to prepare financial plans and requests for credit. BEAR Plus serves as a computerized planning tool. For more information on credit law, refer to the publication "Legal Aspects of Farm Finance".

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## INTRODUCTION

The requirement for farm capital is increasing at a rapid rate. The average capital value of Ontario farms has more than doubled in the last ten years. Nearly thirty billion dollars are invested in commercial farms as real estate, livestock and equipment. Additional money is required for current assets and for personal living expenses. Over five billion dollars of credit are required to finance Ontario farmers.

Studies have indicated that 75% of farms have been mortgaged at some time during the present operator's tenure. Half the current mortgages are held by private individuals, the balance by institutional lenders such as the Farm Credit Corporation, Chartered Banks, Credit Unions and finance companies.

A recent Farm Credit Corporation study found that two-thirds of all Canadian farmers required financing for more than 20% of their capital assets. Since credit may cost farmers up to 25% of the total farm revenue, it is desirable that borrowers understand the purpose for which different types of credit are designed, and the terms and conditions under which credit may be secured.

This publication can serve as a guide to the wise use of credit. It provides information on the cost of credit, the types of loans available and the preparation of a capital budget for the farm business.



# CREDIT ATTITUDES

Credit is the farmer's ability to sell debt or borrow capital. It is another asset that the farmer must manage.

Today's farmer views credit as a tool in the business of farming. Realizing that it takes investment to make money, the farmer must be prepared to pay the price of using credit. The price of using credit is interest.

Some farmers have considered it a disgrace to be in debt and, therefore, use credit as a last resort. Feeling uneasy about borrowing money, they use credit only in emergencies. If they do borrow, they may attempt to repay a loan too quickly, leading to cash availability problems. Without a sufficient supply of capital, these farmers will likely forego many profitable opportunities, thus reducing their earning potential.

Others ask only "Where can I get a loan?" They have not considered fully the risks and costs involved and end up beyond their depth, unable to carry the load.

The business-oriented farmer, who uses credit or borrowed capital to create an efficient and profitable farm, has an attitude between these extremes. He/she has learned about credit, uses it like any other farm asset and is as familiar and comfortable with credit use as with crop production and livestock management. This farmer realizes that the sound use of credit is necessary for a profitable farm operation.

## PRINCIPLES OF SOUND INVESTMENT AND CREDIT USE

How is credit used properly? Consider the three R's of credit — Return, Repayment Capacity and Risk Bearing Ability.

### **Return**

Will the expenditure of additional funds actually pay for itself? Borrowed funds should be used primarily for purposes that will increase net farm income. Cash revenue must cover farm operating expenses, the replacement of depreciable assets, family living expenses and debt retirement. How do you tell when it's profitable to use credit? Prepare a budget on paper first, if the project doesn't show a profit, don't go any farther. Budgeting is a management job and if you are not willing to do it, or to get assistance, you have reduced or eliminated your chances of using credit successfully.

### **Repayment Capacity**

Repayment Capacity is the most critical test of borrowing money. The repayment capacity is the amount of money left over to pay principal and interest on debt. It is total cash revenue minus total cash expenditures (not including interest) minus reserve for asset acquisition minus personal living expenses (including income tax). If principal and interest payments exceed 25% of total farm revenue, the business is in danger. A cash flow projection will allow the borrower and lender to schedule due dates for the repayment of debt.

### **Risk Bearing Ability**

Risk must be accepted by the borrower and the lender. Both must be prepared to take risks in anticipation of earning a profit. Borrowing reduces the owner's equity in the business.

An owner's equity is the front line of risk bearing ability. He must have the ability to cut expenses in a poor market period (leasing, insurances, shared equipment). He must have the ability to borrow in good and bad times.

While risk is an unavoidable element in any enterprise, there are several strategies to control risk:

#### *Marketing Strategies To Reduce Risk*

- Hedging — shifting the risk of price changes to speculators
- Spreading sales — selling product at various times of the year to reduce the risk of price changes
- Contract sales — prices are determined prior to input purchases and profits can be estimated with reasonable accuracy

#### *Financial Strategies To Reduce Risk*

- Maintain a credit reserve — don't borrow to your limit
- Maintain a margin between the cost of borrowing and the income earned from the assets acquired with borrowed capital
- Match repayment period to the useful life of assets acquired with borrowed capital

#### *Production Strategies To Reduce Risk*

- Diversification — have a secondary enterprise (using common asset base)
- Maintain flexibility — be able to adjust cropping or feeding program and keep fixed costs low
- Insurance — crop insurance, income stabilization programs, liability insurance, health and life insurance

## DETERMINANTS OF CREDIT COSTS

Lenders charge interest for the use of their money for the following reasons:

1. Lenders must defer the use of their money when it is lent. This represents a cost to the lender and the borrower must pay this cost.
2. Lenders always face the risk that they will not be repaid because of business failure, borrower's death, borrower's dishonesty, etc. The borrower must offer the lender an incentive to overcome this risk.
3. Lenders face management and administrative costs in making and servicing a loan. These costs must be carried by the borrower.

### Credit Costs

The major influences on the cost of borrowing are the length of the repayment period and the rate of interest charged on the loan. To a lesser extent, the number of payments per year and the number of compounding periods per year also affect the cost of borrowing. The influence of these factors are shown in Tables 1, 2, 3, 4 and 5.

**Table 1. Effect of Repayment Period  
on the Cost of Borrowing**  
(\$100,000 loan at 10% over various time periods)

No. of Years	Annual Payments at 10% Interest	Total Interest Paid over Period
5	\$26,380	\$31,899
10	\$16,275	\$62,745
15	\$13,147	\$97,211
20	\$11,746	\$134,919
25	\$11,017	\$175,420

As seen in Table 1, the length of the repayment period has a very dramatic effect on the total interest paid. This should be taken into consideration when arranging credit. As seen above, increasing the annual payment from \$11,017 (25 yr) to

\$13,147 (15 yr), an increase of \$2,130/year, decreases the total interest paid by \$78,209 over the period of the loan.

**Table 2. Effect of Interest Rate  
on the Cost of Borrowing**  
(\$100,000 over 25 years at various interest rates)

Interest Rate	Annual Payment	Total Interest Paid
6%	\$7,823	\$95,567
8%	\$9,368	\$134,197
10%	\$11,017	\$175,420
12%	\$12,750	\$218,749
14%	\$14,550	\$263,745
16%	\$16,401	\$310,030
18%	\$18,292	\$357,295

Table 2 supports the need for borrowers to obtain the lowest possible interest rate available. An increase from 8% annual interest to 12% causes an \$84,552 increase in interest payments over the 25-year loan period and increases the annual payment by \$3,382 per year.

**Table 3. Effect of the Number of Payments  
Per Year on the Borrowing Cost**  
(\$100,000 at 10% over 25 years at various numbers of payments per year)

Payments/year	Annual Payment	Total Interest Paid
1	\$11,017	\$175,420
2	\$10,754	\$168,858
4	\$10,626	\$165,654
6	\$10,584	\$164,597
12	\$10,542	\$163,544

Table 3 demonstrates that annual payments and total interest paid are reduced as the number of payments per year is increased.



**Table 4. The Effect of Given Interest Rates on the Annual Payment per \$1 of Loan for Different Maturities**  
(Amortization Table showing the size of annual payment per \$1 borrowed for various interest rates and time periods)

Years	Interest Rate								
	8%	9%	10%	11%	12%	13%	14%	15%	16%
1	1.0800	1.0900	1.1000	1.1100	1.1200	1.1300	1.1400	1.1500	1.1600
2	.5607	.5684	.5761	.5839	.5916	.5994	.6072	.6151	.6229
3	.3880	.3950	.4021	.4092	.4163	.4235	.4307	.4379	.4452
4	.3019	.3086	.3154	.3223	.3292	.3360	.3432	.3502	.3573
5	.2504	.2570	.2637	.2705	.2774	.2843	.2912	.2983	.3054
6	.2163	.2229	.2296	.2363	.2432	.2501	.2571	.2642	.2713
7	.1920	.1986	.2054	.2122	.2191	.2261	.2331	.2403	.2476
8	.1740	.1806	.1874	.1943	.2013	.2083	.2155	.2228	.2302
9	.1600	.1667	.1736	.1806	.1876	.1948	.2021	.2095	.2170
10	.1490	.1558	.1627	.1698	.1769	.1842	.1917	.1992	.2069
11	.1400	.1469	.1539	.1611	.1684	.1758	.1833	.1910	.1988
12	.1326	.1396	.1467	.1540	.1614	.1689	.1766	.1844	.1924
13	.1265	.1335	.1407	.1481	.1556	.1633	.1711	.1791	.1871
14	.1212	.1284	.1357	.1432	.1508	.1586	.1666	.1746	.1828
15	.1168	.1240	.1314	.1390	.1468	.1547	.1628	.1710	.1793
16	.1129	.1203	.1278	.1355	.1433	.1514	.1596	.1679	.1764
17	.1096	.1170	.1246	.1324	.1404	.1486	.1569	.1653	.1739
18	.1067	.1142	.1219	.1298	.1379	.1462	.1546	.1631	.1718
19	.1041	.1117	.1195	.1275	.1357	.1441	.1526	.1613	.1701
20	.1018	.1095	.1174	.1255	.1338	.1423	.1509	.1597	.1686
25	.0936	.1018	.1101	.1187	.1275	.1364	.1454	.1546	.1640

Table 4 shows the difference in annual payments for given interest rates and time periods. Annual payments on \$100,000 borrowed for 20 years at 8% would equal \$10,180. The annual payments on \$100,000 borrowed for 20 years at 14% would equal \$15,090. To pay the 8% loan of \$100,000 off in 15 years requires payments of \$11,680 per year. At 14% over 15 years the payments are \$16,280.

**Table 5. Effect of the Number of Compounding Periods Per Year on Borrowing Cost**  
(\$100,000 loan at 10% interest over 25-year period)

Compounding Periods/Yr	Annual Payment	Total Interest Paid
1	\$11,017	\$175,420
2	\$11,229	\$180,730
4	\$11,341	\$183,532
6	\$11,379	\$184,489
12	\$11,418	\$185,458

Table 5 demonstrates that both the annual payment and the total amount of interest paid over the repayment period increases with the number of compounding periods.

In general, borrowers have little control over most of the factors affecting the borrowing costs when dealing with large lending institutions. The Farm Credit Corporation and most Chartered Banks compound the interest on mortgage payments twice per year, while some short-term loans may be compounded twelve times per year. Borrowers should be aware that as the number of compounding periods increases, so does the effective rate of interest.

It is assumed that borrowers are going to obtain their credit from the institutions offering the lowest rate of interest, thus keeping the cost of credit to a minimum. For this reason, most financial institutions have competitive lending rates, but this cannot be assumed by the borrower. Reference to Table 2 illustrates the importance of acquiring credit at the lowest possible rate.

Borrowers have a large measure of discretion in selecting the length of repayment for a loan. Table 1 indicates that the choice of repayment period can have a significant savings in total interest paid. While very significant savings in total interest paid are available through shorter repayment schedules, borrowers must be **cautioned** not to select too short a repayment period. This may cause a farm business to run into a cash availability problem.

#### Other Charges

In addition to interest charges, other charges are often included in credit packages. These include service charges, investigation fees, mortgage application fees, appraisal fees, disbursement costs and insurance premiums. Any of these items is a credit related charge and raises the cost of borrowing.

# DEBT SERVICING REQUIREMENTS

The debt servicing requirement of a business can be defined as the amount of interest and principal that must be paid annually.

In many situations, when the analysis of a farm business is being completed, the section on debt servicing requirements is omitted. Debt servicing is often omitted because the farm manager does not know the amount of principal outstanding, the interest rate charged or how the interest is calculated by the different creditors.

The method of calculating interest varies from one creditor to another. Therefore, it is necessary for the farm manager to contact the different lending agencies to determine the rate of interest charged and how the interest is calculated. This information can then be recorded on the debt servicing worksheet (Figure 1).

## Current Liabilities

When calculating the debt servicing requirements of a business, it is advisable to start with current liabilities. Accounts payable, property tax arrears, and bank operating loans fall under this category.

### Example A

The method used to calculate the amount of interest and the rate of interest will vary from one creditor to another. Some creditors calculate interest as follows: on the 30th day of the month following delivery, if the principal is not paid, interest will be compounded monthly at the rate of 2% to 3% on the outstanding balance.

Amount owing (beginning) = \$1,000  
Assume no principal paid for twelve months  
Interest rate = 2% / month on outstanding balance  
(compounded monthly)  
Annual interest charged = \$268

### Example B

The rate of interest charged on property tax arrears will vary from one township to another. Some townships calculate interest as follows:

Installment due = \$1,000  
Assume installment due not paid for twelve months  
Interest calculated annually on the outstanding principal  
Interest rate = 2% / month  
Annual interest charged = \$240

### Example C

The rate of interest charged on operating loans, and the method used to calculate interest will vary from bank to bank. At some banks, interest may be compounded on the outstanding balance either monthly or annually. When the interest is compounded annually, the rate charged will usually be 1/2% to 3/4% higher than if interest was compounded monthly. The following shows interest paid monthly on a \$10,000 operating loan:

Bank operating loan = \$10,000  
Assume operating loan principal remains constant over 12 months

Interest rate = 11%		
Interest compounded	annually	monthly
Monthly interest paid	\$91.67	\$92.40
Annual interest paid	\$1,100	\$1,109

## Term Liabilities

### Example D

The method of calculating annual interest and principal on term liabilities will vary from one lending institution to another. At some banks, annual interest and principal may be calculated as follows: the loan is amortized with equal monthly payments, but the amount of principal and interest varies from month to month, starting with small principal payments and ending with large ones. The monthly interest payments follow the opposite pattern.

The following describes an amortized loan with equal payments of varying portions of principal and interest:

Amount of money borrowed = \$40,000  
Term = 5 years  
Interest rate = 11% (compounded semi-annually)  
Number of payments per year = 12  
Annual payments = \$10,378  
Interest paid first year = \$3,994  
Principal paid first year = \$6,384

Another method would amortize the loan with a fixed monthly payment and variable interest rates. If interest rates decrease the payment remains fixed and more principal is retired.

### Example E

Farm machinery companies also finance the purchase of new farm equipment. The interest rate will vary from one company to another. Some companies include a charge for life insurance and machinery insurance in the payment. Farmers wishing to calculate interest and other charges can do so by multiplying the amount of the payment by the total number of payments. This information can be obtained from the service contract. By subtracting the principal payments from the total outlay, the interest and service charges can be obtained. Divide this number by the term of the loan to arrive at the annual cost of the loan.

Amount financed = \$10,000  
Term = 3 years  
Interest rate = 14% (compounded annually)  
Number of payments per year = 2  
Amount of payment = \$2,198 paid twice annually  
Total money repaid = \$2,198 x 6 = \$13,188  
Less principal paid = \$10,000  
Total interest and service charges = \$3,188  
Total interest paid = \$2,588  
Annual interest payment = \$862 (average)  
Annual service charge = \$200  
Annual principal payment = \$3,333 (average)

### Example F

In some situations, loans between parents and children are non-amortized. In these situations, interest is compounded annually on the principal outstanding.



The following shows an amortized loan with equal payments but varying portions of principal and interest in each payment:

Amount of money borrowed = \$100,000

Amortization period = 20 years

Interest rate = 12% (compounded semi-annually)

Number of payments per year = 2

Amount of payment = \$6,646 paid twice annually

Interest paid first year = \$11,961

Principal paid first year = \$1,331

For each year the loan has payments totalling \$13,292, but the amount of principal and interest varies each year. For example, in the last year of this loan the interest payment would be \$1,107 and the principal payment would be \$12,185.

## DEBT SERVICING WORKSHEET

By summarizing Examples A to F in Figure 1, the total annual interest and principal payments can be calculated. This is the amount of debt a business must service in a given year.

In Figure 1 a total debt servicing obligation amounts to \$31,672.

Figure 1. Debt Servicing Requirements

CURRENT LIABILITIES	Balance Start of Year	Int. Rate	Annual Payments		Balance End of Year
			Interest	Principal	
EXAMPLE A	\$1,000.	2% mo.	268.	1,000.	Ø
EXAMPLE B	1,000.	2% mo.	240.	1,000.	Ø
Operating Loan EXAMPLE C	10,000.	11%	1,100	Ø	10,000.
Sub-Total	12,000.		1,608.	2,000.	10,000.

### TERM LIABILITIES

EXAMPLE D	40,000.	11%	3,993	6,384	33,616
EXAMPLE E	10,000.	14%	1,062 <sup>Ⓜ</sup>	3,333	6,667
EXAMPLE F	100,000.	12%	11,961	1,331	98,669
<sup>Ⓜ</sup> includes service charge					
Sub-Total	150,000.		17,016	11,048	138,952
Grand Total	162,000.		18,624	13,048	148,952

Total Interest and Principal Payments  
(Debt Servicing Requirement)

31,672

## DEBT SERVICING CAPACITY

The debt servicing capacity of a business may be defined as the ability to pay annual interest and principal after other cash expenses and family living have been paid. Debt is paid from cash flowing into the business. Sources of cash revenue would include sales of crops, livestock, livestock products, custom work, off-farm revenue and personal revenue. Demands on cash revenue would be cash operating expenses, personal cash withdrawals, income tax and a reserve for asset acquisition.

Many prudent managers will set aside a reserve for the

acquisition of new or replacement assets. The amount set aside will vary depending upon the cost of the new assets.

Figure 2. illustrates how debt servicing capacity can be calculated. The residual is the amount of money available for paying interest and principal.

Referring to the following Table 6, we see that this business has the capacity to service a debt of \$91,866, assuming 10% interest and a 20-year debt repayment period. This was determined using the factor 10.790 times \$8,514.

Figure 2. Debt Servicing Capacity Calculation

Farm Cash Revenue	\$ 126,816
- Farm Cash Expenses	( 85,555 )
= Net Cash from Operations	\$ 41,261
+ Interest Payments	17,529
+ Owner's Contributions	0
- Owner's Withdrawals	( 18,000 )
- Reserve for Asset Acquisition	( 10,000 )
= Debt Servicing Capacity	\$ 32,790

Table 6. Debt Carrying Capacity per \$1,000 Annual Payment  
(One payment per year and one compounding period per year)

Years	Interest Rate					
	6%	8%	10%	12%	14%	16%
5	4,212	3,993	3,791	3,605	3,433	3,274
10	7,360	6,710	6,144	5,650	5,216	4,833
15	9,712	8,559	7,606	6,812	6,142	5,577
20	11,470	9,818	8,514	7,468	6,622	5,929
25	12,783	10,675	9,077	7,843	6,873	6,098
Table 1 (a)						
*	16,667	12,500	10,000	8,333	7,143	6,250

\*Interest payment only per annum, no principal payment. Eg. This shows that \$1,000 will service the interest payment on \$10,000 credit annually at 10% interest.

## COMPARING DEBT SERVICING CAPACITY TO DEBT COMMITMENTS

In some situations, a farm business does not have adequate debt servicing capacity to meet its debt obligations.

The ability of the farm manager to project how much principal and interest the business can pay annually is most important. It is also important for the farm manager to know how much interest and principal will have to be paid annually. These two items must be projected annually and there should be an adequate margin between the two. This will compensate

for a decrease in commodity prices or an increase in input costs or other factors affecting revenues and expenses.

When a business finds itself in a position where its debt obligations are greater than its debt servicing capacity, adjustments must be made from within. This could involve debt restructuring, or downsizing by the liquidation of capital assets.

## FUNCTION OF LENDERS

At any point in time, society has both savers and spenders. Savers take in more money than they spend and have excess funds. Spenders may not have enough cash to cover their expenses.

Lenders pool savers' funds and then lend to borrowers. Lenders perform a vital service by matching borrowing needs of some with the saving needs of others. Savers do not have to worry about the risk of making any one specific loan.

## WHY DO LENDERS MAKE LOANS?

The lender will try to find the best and safest use for the savers' funds. Lenders must try to protect the deposits of savers and also generate profit for their owners. Lenders must lend money wisely to its most productive use. When you apply

for a loan you are, in fact, asking to borrow other people's money. Lenders provide money to a variety of customers; from small farmers to large manufacturing companies.

## RULES THAT MUST BE FOLLOWED IN LENDING

Rules for lenders are set by governments in appropriate legislation. Appointed inspectors make sure these rules and regulations are followed. Lending institutions can only be helpful if you wish to borrow money ("debt" financing)

which you must repay. These institutions cannot help by becoming part owners ("equity" financing) of a farm business.

## WHAT THE LENDER CONSIDERS IN MAKING A LOAN

When you apply for a loan, you must fill out a loan application. You will be asked to prepare a business plan and a forecast of your cash inflows and cash outflows. The lender will also need other statements of your financial position such as balance sheets and income statements. Information to help you in preparing these documents is available at local bank branches, agricultural representative offices and various accounting firms. It is well worth looking into these sources of information as the lender will put a great deal of emphasis on your business plan and cash flow forecasts.

The lender must be satisfied that you will be able to repay the borrowed money. The amount available, terms of repayment, interest rate and what you offer to back up your loan (collateral security) are items that will be discussed when applying for a loan.

To find out about your credit needs and ability to repay, the lender will want information relating to your personal abilities and business experience.

Inquiries will be made to assess the following:

- (a) Your farming experience
- (b) Your organizational and management skills
- (c) Your health
- (d) Your character
- (e) Your problem-solving ability

Knowledge of your background will help determine your credit-worthiness. The following is a sample list of questions used to assist the lender in analyzing your credit worthiness:



### Money-Related Questions

1. Is your information reliable? Can the lender trust your numbers?
2. Have any major changes occurred to the farm operation lately? If yes, have the results been positive?
3. Do you keep up-to-date cost figures? How often are accrual income statements prepared?
4. Do you have enough cash and financing in relation to sales, both now and in the future?
5. Is your equipment in good working order? How much is it worth today?
6. Do you have enough insurance?
7. Do you have past debts owing and does anyone have claims on your assets?
8. How have your past expenses and net farm income compared to sales?
9. How have your net income and return on investment compared to others in your industry?

## WHY DO LENDERS REQUIRE COLLATERAL SECURITY?

The amount and terms of your loan depend upon your basic ability to repay the loan. Collateral security is what you offer to back up your loan. Lenders take collateral security for three reasons.

Security is taken as a form of insurance against loan losses. If you do not repay the loan, the lender may take possession and sell your security ("realize on your security"). The proceeds will be used to cover your debt.

### Questions on Assets and Markets

1. What type of inventory do you have — livestock, grain and supplies?
2. Is your product mix satisfactory? Should you be adding or dropping products?
3. How does your production of crops and livestock compare to others in your industry?
4. When products are marketed, what condition are the products in? Do goods spoil? How fast do they spoil?
5. What is your marketing strategy?
6. What are the results of this strategy for past years?
7. Do you use forward contracts?
8. What is the current economy like? Has the demand for your product been affected? Is it likely to be affected in the future?
9. Is new technology making your old equipment less useful?

When you borrow money, the lender has a claim on you for repayment. But, if you owe money to more than one lender, different lenders may hold various claims on your assets. When the lender has a "secured" claim it means the lender will be paid ahead of unsecured creditors if you become insolvent. This protects the lender's legal position.

If you provide security, you should be more concerned about repaying your loan as scheduled.

## WHAT SECURITY WILL THE LENDER ASK FOR?

In choosing the amount, strength and type of security to request from you, the lender will consider: the type of loan you need, the size of the loan, the reason you need the loan, and the time it will take to repay the loan.

There are basically two types of loans. An operating loan is used to finance inventory and farm production expenses. The

lender would usually request inventory or receivables as security.

A term loan can be used to purchase new machinery. The loan is repaid over an extended period of time. The loan would likely be secured by fixed assets such as land, building, machinery or equipment.

## EVIDENCE OF LOAN

Lenders require written proof of your promise to repay the loan. Where no security is taken, a promissory note, which is a written promise to pay, is usually required. Where security is taken, other documents are required. The type of document required depends on security taken to support the loan.

Security documents usually state the amount loaned, the interest rate, the term of the loan, the date of repayment, the conditions of control on operations and consequences if you default in your payments.

## SECURITY INVOLVING REAL ESTATE

### Mortgages

Signing a mortgage creates a claim on land or buildings for the repayment of the loan. After a loan is repaid, the lender has no claim on the property. While outstanding, the lender still has a claim on the property to the extent of the indebtedness.

However, if you do not repay the loan, the lender can take legal action to sell the property and use the proceeds to repay the loan. To repossess the security, the lender can act only if appropriate notice is given and correct legal processes are followed.

## SECURITY INVOLVING OTHER ASSETS

Other security agreements relate to all other assets excluding land and buildings.

### Federal Law: Section 178, Bank Act

This federal legislation allows banks to lend money and to take security on crops, livestock, equipment or implements. For example, a farmer engaged in livestock farming may receive a loan with security taken on all or on specified items of livestock. Similarly, a cash crop operation may provide crops, growing or in storage on the farm, as security. In the event the loan is not repaid, the bank has the right to repossess the pledged security, sell it and use the proceeds to reduce the loan.

### Provincial Law: Personal Property Security Act

*General Security Agreement.* A General Security Agreement provides a continuing charge, and may be used to cover all assets except real estate. Usually, the agreement specifies a fixed amount. For example, equipment or vehicles would be specifically identified by a serial number in a fixed charge. In addition, there may be a floating charge on all of your property which gives lenders the right to sell any property upon default of payment.

*General Assignment of Book Debts.* The borrower's "Book Debts" are accounts receivable. In other words, they are

monies owing to the farmer for supplies, goods or services provided, but for which no payment has been received. As a common lending practice, it is desirable for the lender to hold a General Assignment of the accounts receivable. This security is seldom realized unless the farm's affairs become strained. In this situation, the security is of little value because the borrower usually collects the amounts easily obtained, leaving the slow accounts to be collected by the lender. If a default in payment occurs, the Assignment allows the lender to contract and collect monies directly from those that owe money. The funds received are then applied to repay the customer's loans.

*Chattel Mortgage.* A chattel mortgage is a security agreement whereby a borrower grants to the lender a claim on specific equipment or machinery. The assets remain in the physical possession of the borrower, but are used as security against the payment of a debt. Chattel mortgages may be taken to secure new as well as existing demand loans. The obligations for a chattel mortgage are similar to those of a real estate mortgage.

*Conditional Sales Agreement.* If you purchase goods and the seller keeps ownership of the goods until you have fully paid for them, this arrangement is known as a conditional sale. The title transfers from the seller to the purchaser when the goods are fully paid for.

## GUARANTEES

A guarantee may be provided by a person or business associate who has an interest in seeing the business succeed. The lender may request a guarantee by a third party as a show of good faith. If the loan cannot be repaid, the guarantor will make the payment to fulfil the debt obligation on behalf of the borrower.

### Postponements of Claims

A postponement agreement is a formal agreement which postpones repayment of debts or obligations to third parties until the bank loans are repaid. It is often requested when a borrower, such as a company or individual, owes substantial amounts to the shareholders, affiliated companies or relatives. These individuals are asked to postpone their payments until other loans are paid.

## WARNING ON TECHNICAL LEGAL TERMS

The law presumes that you have fully understood any security agreement that you have signed. You should obtain legal advice to ensure this understanding. Security documents are usually written in complex, technical, legal language. Sometimes the documents are wider in scope than is strictly

necessary. For example, guarantees are sometimes given for unlimited amounts and they may state that the lender can demand payments from your spouse (guarantor) even though the lender has not realized on his security.

## CONDITIONS SPECIFIED FOR OPERATIONS

For the protection of both borrower and lender, lenders often want to monitor the farming operations. Security agreements may specify restrictions on the operations. The

borrower may be required to: (a) maintain a certain amount of cash, (b) put limits on family withdrawals; and (c) limit purchases of machinery and equipment.



## HOW DO LENDERS DETERMINE THE INTEREST RATE?

The interest rate you pay on loans is the cost of borrowing money. Lenders consider many factors when choosing a rate to charge borrowers.

First, the central bank (Bank of Canada) sets the basic price for money (the Bank Rate). This Bank Rate is affected by the supply and demand conditions for all loanable funds. The specific costs of making each loan must be added to this Bank Rate. Two costs the lenders must cover are credit risk and costs of processing and servicing the loan. Loans that are more risky are usually charged a higher rate.

A bank charges its most credit-worthy customers the Prime Rate. This rate is set above the Bank Rate and is established

periodically by most banks. The loan rate provided to most customers will usually be stated as the Prime Rate plus an additional charge.

Interest rates can be fixed for the term of the loan, meaning they remain the same rate for the entire term. On the other hand, floating rates that are set at a certain rate over the prime rate can be used. The effective rate you are charged will then fluctuate as the prime rate moves up or down. For instance, if a loan is at prime plus 2%, when prime is 8%, the effective rate is 10%. When prime is 12%, the effective rate is 14%.

Loans can be current or term. Interest rates on term loans are often higher than interest charged on current loans.

## EMERGING FINANCIAL CRISIS

If your business is experiencing financial difficulty, it is important that you discuss this difficulty with your lender. Both parties will be better off trying to improve the situation. The borrower should review business performance throughout the year to catch problems before they get out of hand.

Should the business become temporarily short of funds to service the debt, there may be several financial options available to relieve this problem. These include the following:

1. The operating line of credit can be renegotiated.
2. The repayment period could be lengthened on term loans.
3. The lender could grant more loans covered by mortgage security. This might help meet future production levels.
4. Perhaps some of the farm assets could be sold. In the future, the borrower could lease or rent land, machinery and equipment.

## DEFAULT AND ENFORCEMENT OF SECURITY

### Power of Sale

If a default in payment of a mortgage occurs, lenders usually have the power to sell the security (usually land and buildings). A sale occurs only if appropriate notice is given and correct legal processes are followed. If the proceeds of the sale exceed the amount of the outstanding balance of the mortgage, the borrower would receive this amount, less any charges incurred in disposing of the assets.

### Foreclosure

Foreclosure is an alternative action to a power of sale. When a default in payment of a mortgage occurs and there is little likelihood other payments will be made, the lender may go through the courts to take legal action. Title passes to the lender who becomes the absolute owner of the property. The lender is free to sell the land and buildings and the proceeds are used to pay off the debts.

### Receivership

Under a general security agreement, receivers may be appointed by the lender. Appointment of a receiver may be made if payments are missed or other obligations are not fulfilled. A receiver has the power to take control of the assets, manage them and sell them.

### Bankruptcy

The lender cannot force an unincorporated farmer into bankruptcy. However, a farmer can make a voluntary declaration of bankruptcy. Farm assets are then given to a trustee. The trustee would divide and sell the assets and give the proceeds to various creditors, based on their priority. The farmer would then be released from all debt obligations.







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